United States Court of Appeals

for the Second Circuit

AMICUS BRIEF

77-7183
77-7186

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

EDWARD S. REDINGTON, et al.,

Plaintiffs-Appellants,

v.

TOUCHE ROSS & CO.,

Defendant-Appellee.

Appeal From the United States District Court
for the Southern District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION,
AMICUS CURIAE

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PAUL GONSON
Associate General Counsel

JAMES H. SCHROPP
Assistant General Counsel

THEODORE S. BLOCH
Attorney

Securities and Exchange Commission
Washington, D.C. 20549

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BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE

PRELIMINARY STATEMENT

This is an appeal from an order entered by the United States District Court for the Southern District of New York on March 15, 1977, in which the Honorable Inzer B. Wyatt granted the defendant's motion to dismiss an action to recover damages for alleged violations of Section 17 of the Securities Exchange Act of 1934, 15 U.S.C. §78q, for failing to state a claim for which relief can be granted.

On May 24, 1973, the Securities Investor Protection Corporation ("SIPC") filed an application in the lower court, pursuant to Section 5(a)(2) of the Securities Investor Protection Act ("SIPA"), 15 U.S.C. §78eee(a)(2), asking the court to adjudicate under Section 5(b)(1) of SIPA, 15 U.S.C. §78eee(b)(1), that customers of Weis Securites Inc. ("Weis"), a broker-dealer

registered with the Securities and Exchange Commission, were in need of the protection afforded by SIPA and to appoint a trustee and an attorney under Section 5(b)(3) of SIPA, 15 U.S.C. §78eee(b)(3). The district court granted the application on May 30, 1973, 1/ and Weis has since that date been in liquidation under SIPA.

On April 30, 1976, SIPC and the Trustee, Edward S. Redington, began this action against the defendant Touche Ross, Inc., seeking to recover funds paid out by SIPC as a result of the allegedly willful or reckless failure of Touche Ross, a firm of certified public accountants, properly to perform auditing services in connection with financial statements required to be filed with the Commission pursuant to Rule 17a-5 under Section 17 of the Securities Exchange Act, 17 CFR 240.17a-5. SIPC asserted claims, under Section 17 and common law, both in its own right and as the subrogee of Weis' customers whose claims were satisfied through the payment, from SIPC's funds, of more than fourteen million dollars. 2/

ISSUE PRESENTED

May the Securities Investor Protection Corporation assert a private right of action under Section 17 of the Securities Exchange Act to recover monetary damages it sustains as a result of the willful or reckless failure of a firm of certified public accountants to perform an adequate

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1/ See Exchange National Banks v. Wyatt, 517 F.2d 453 (C.A. 2, 1975).

2/ A more detailed statement of the facts is set forth in the opening brief filed by SIPC ("SIPC Brief") at pp. 3-13.

audit of the financial statements of a broker and dealer in securities? 3/

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Commission respectfully submits this brief as amicus curiae because this appeal raises significant issues which could materially affect its administration of the federal securities laws. We believe, as discussed infra, that permitting a private right of action under Section 17 of the Securities Exchange Act will provide a necessary supplement to the Commission's efforts to enforce that section and the rules and regulations thereunder. In addition, financial statements submitted by broker-dealers pursuant to the Act play a key role in the Commission's administration and enforcement of various statutory provisions designed to protect against loss of the funds and securities of customers of broker-dealers and to maintain confidence in the securities markets at a high level. The availability of a right of action under Section 17 will thus have a direct bearing on the overall effectiveness of such statutory and regulatory provisions as those regarding hypothecation and segregation of securities and cash, and the net capital rule, designed to ensure the ability of brokers to meet their financial obligations as custodians of customer property. 4/ In addition, the Commission has "plenary authority" with respect to the operations of the Securities

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3/ Because the complaint was dismissed on the motion of the defendant-accounting firm, the material facts alleged therein are deemed true for the purpose of this appeal. Of course, there were no findings of fact in the lower court.

4/ See, e.g., Section 15(c)(2) of the Securities Exchange Act, 15 U.S.C. 78o(c)(2), and Rules 15c2-1, 15c3-1 and 15c3-3 thereunder, 17 CFR 240.15c2-1, 15c3-1 and 15c3-3.

Investor Protection Corporation, 5/ and is therefore concerned that SIPC have the ability to recover funds needlessly expended due to the wrongful acts of others, thus preserving the funds available to compensate losses suffered by the customers of brokers. 6/

ARGUMENT

THE SECURITIES INVESTOR PROTECTION CORPORATION MAY ASSERT A PRIVATE RIGHT OF ACTION FOR VIOLATIONS OF SECTION 17 OF THE SECURITIES EXCHANGE ACT.

Just as this Court in Abrahamson v. Fleschner, ___ F.2d ___, [1976-77] CCH Fed. Sec. L. Rep. ¶95,889 (1977), recently held that a right of action is implied for violations of a provision of the federal securities laws which does not explicitly provide for private remedies, we believe that a private right of action should be implied for violations of Section 17 of the Securities Exchange Act. 7/ The Court indicated that a determination of this question requires an examination of the factors enunciated by the

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5/ Securities Investor Protection Corporation v. Barbour, 421 U.S. 412, 417 (1975).

6/ Due to its particular concern with the operations of SIPC, the Commission's brief is limited to the issues raised by SIPC's assertion of a cause of action under Section 17. Although no opinion is expressed as to the merits of the positions taken in the brief of the SIPC trustee, Edward S. Redington, this Court should not infer that the Commission is inhospitable to the views expressed in that brief.

7/ In Abrahamson, the Court considered the question whether a private remedy exists for violations of Section 206 of the Investment Advisers Act, the antifraud provision of that Act. On April 15, 1977, the Court granted petitions for rehearing in Abrahamson, limited to the issue whether the defendants in that action were "investment advisers" within the definition contained in the Investment Advisers Act.

Supreme Court in Cort v. Ash, 422 U.S. 66 (1975), an approach which was specifically reaffirmed by the Supreme Court in Piper, et al. v. Chris-Craft Industries, Inc., et al., ___ U.S. ___, ___, [1976-77] CCH Fed. Sec. L. Rep. ¶95,864 at 91,160 (1977). The factors cited in Cort, 422 U.S. at 78 (emphasis in original), are:

> "First, the plaintiff 'one of the class for whose especial benefit the statute was enacted' * * *— that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? * * *. Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? * * * And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?"

See Abrahamson v. Fleschner, supra, [1976-77] CCH Fed. Sec. L. Rep. ¶95,889 at 91,274 (1977).

Each of these four considerations is not a prerequisite to an implied right of action, but only a "factor" to be taken into consideration. The Commission submits that an examination of these factors indicates that an implied right of action under Section 17(a) of the 1934 Act fully satisfies each of the criteria enunciated by the Supreme Court in Cort.

A. SIPC, and Those Investors to Whose Interests It Succeeds, are Members of the Class for Whose Especial Benefit the Statutory and Regulatory Scheme Here Involved was Created.

There is a strong presumption that the beneficiaries of a statutory or regulatory provision may enlist the aid of the courts to obtain redress for any violation of a provision designed for their benefit, particularly when necessary to implement the statute's underlying purposes. Abrahamson v. Fleschner, supra, [1976-77] CCH Fed. Sec. L. Rep. at 91,273),

citing, Superintendent of Insurance v. Bankers Life and Casualty Co., 404 U.S. 13 n.9 (1971); J. I. Case Co. v. Borak, 377 U.S. 426 (1964); Tunstall v. Brotherhood of Locomotive Firemen and Enginemen, 323 U.S. 210 (1944); Texas and Pacific R.R. v. Rigsby, 241 U.S. 33 (1916).

The need for the Securities Exchange Act of 1934 stemmed from a belief that "* * * unregulated speculation in securities and in commodities was one of the most important contributing factors in the artificial and unwarranted 'boom' which had so much to do with the terrible conditions of the years following 1929 * * *." 8/ The Congress recognized that the "causes of dangerous speculation" were complicated and inter-related. "Speculation, manipulation, faulty credit control, investors ignorance, and disregard of trust relationships by those whom the law should regard as fiduciaries, are all a seamless web;" 9/ accordingly, the Act's remedial provisions were designed to be complimentary. Moreover, the function of the Securities Exchange Act was to advance the law in this area by a "constant extension of the legal conception of a fiduciary relationship—a guarantee of 'straight shooting' * * *." 10/ Recognizing that "the complicated nature of the problems justified much greater latitude of discretion with the administrative agencies than would otherwise be the case * * * the bill in dealing with a number of difficult problems singles out these problems as matters appropriate to be subject to restrictive

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8/ Letter from President Roosevelt to the Honorable Sam Rayburn, Chairman, Interstate and Foreign Commerce Committee, House of Representatives, March 26, 1934, reprinted in H.R. Rep. 1383, 73d Cong., 2d Sess. 2 (1934).

9/ H.R. Rep. No. 1383, 73d Cong., 2d Sess. 6 (1934).

10/ Id. at 5.

rules and regulations, but leaves to the administrative agencies the determination of the most appropriate form of rule or regulation to be enforced." 11/

Section 17 of the Securities Exchange Act has as its specific stated purpose the protection of investors in securities; 12/ more particularly, it is aimed at the protection of customers of registered brokers and dealers against losses of cash and securities resulting from the insolvency

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11/ Id. at 6.

12/ Except for minor changes to conform it to amendments to Section 15 and 15A in 1936 and 1938 respectively, it was enacted in the same form in which it existed in 1972, when the alleged violations by Touche Ross occurred. In 1972, Section 17(a) provided, in relevant part:

> "Every national securities exchange, every member thereof, every broker or dealer who transacts a business in securities through the medium of any such member, every registered securities association, and every broker or dealer registered pursuant to Section 78o of this title, shall make, keep, and preserve for such periods, such accounts, correspondence, memoranda, papers, books, and other records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors."

The Securities Acts Amendments of 1975, P.L. 94-29 (June 4, 1975), made extensive changes to Section 17 which strengthened the reporting scheme implemented by the Commission pursuant to the rule-making authority conferred by Section 17. Certain classes of persons, including registered municipal security dealers, registered security information processors, registered transfer agents, registered clearing agencies and the Municipal Securities Rulemaking Board, were added to the list of persons subject to the Commission's reporting requirements. Moreover, under new Section 17(e), registered brokers and dealers must furnish to their customers both the annual audited reports required to be filed with the Commission since 1942, infra, p. 6 and unaudited statements to be prepared by no later than six months after the date when the audited statements are filed with the Commission.

of the brokers. 13/ In implementing the regulatory scheme authorized by Section 17, the Commission has had these interests foremost in mind. Thus, when Rule 17a-5 was originally adopted in 1942, subsection (a) of the rule required that broker-dealers file with the Commission annual reports indicating their financial condition. Subsection (b) of the rule provided, however, that these reports did not have to be audited unless the broker was required to file such financial statements by state law or the rules of a national securities exchange, or if he

> "made a practice of (a) extending credit in any form to customers * * *; (b) holding securities owned by customers, except as incident to transactions with or for customers which are promptly consummated by delivery; or (c) carrying credit balances of customers, except as an incident to transactions with or for customers which are promptly consummated by payment * * *." 14/

The fact that broker-dealers who did not hold money or securities of their customers, or did not owe them money, were exempted from the requirement that their financial statements be audited indicates, of course, that the purpose of the auditing requirement is to provide substantial protection to customers who left their money or securities in the control of their brokers.

13/ The definition of "customer" set forth in Rule 17a-5(c)(4) specifically includes

> "any person for whom the broker or dealer holds securities for safekeeping or as collateral or for whom the broker or dealer carries a free credit balance * * *."

17 CFR 240.17a-5(c)(4).

14/ 7 Federal Register 9917, December 1, 1942.

The lower court appeared to suggest, somewhat myopically, that Section 17 was designed for the benefit of brokers or accountants, stating: "* * * it would appear that Section 17 was designed to supply administrative guidance in the bookkeeping area and not to create rights in anybody" (A. 400a). 15/ This would appear, however, to be an unduly narrow interpretation of a statute which indicates, on its face, its primary concern with "the public interest [and] the interest of investors."

The key role that the audit of financial statements submitted by brokers and dealers plays in the regulatory scheme was aptly described in the Commission's "Study of Unsafe and Unsound Practices of Brokers and Dealers," Report and Recommendations of the Securities and Exchange Commission, H. Doc. No. 92-231, 92d Cong., 1st Sess. (December 1971) at p. 24 (footnotes omitted) (emphasis added). The Commission noted that

> "* * * in 1955, when it had under consideration the expansion of the certification requirements for such [Section 17(a)] reports, the Commission indicated that, with the broader proposed certification requirements, customers having substantial amounts of securities with their broker-dealers 'should have the protection afforded through examination of the financial statements of such brokers and dealers by independent accountants.' And, when the Commission ultimately adopted the expansion of the certification requirements in 1957, that step represented the Commission's considered view that <u>those certification and reporting requirements constituted a valuable regulatory tool for the protection of a customer in respect of the risks involved in leaving his money and securities with his broker-dealer</u>. This was evidenced not only by the exemption in Rule 17a-5 from its certification

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15/ The Joint Appendix filed in this appeal is cited "A__a."

> requirements accorded to brokers and dealers who do not hold funds and securities of customers but also by the Commission's observation at that time that, as distinguished from inspections upon which it primarily relied for testing compliance with applicable regulatory requirements, the certifications by the accountant were to serve as the barometer of the broker-dealers' financial conditions."

Like the Commission itself, SIPC is dependent to a considerable degree upon the performance of proper audits if it is to fulfill its statutory mission. 16/ The legislation creating SIPC was enacted in response to the

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16/ The dependence of the Commission and the public on audits conducted by independent accountants did not come about by accident. Congress first considered, but ultimately rejected, the notion that Government accountants should audit financial statements submitted to it pursuant to the securities laws. At the behest of the accounting profession, however, this responsibility was assigned to the independent auditor. See, e.g., the colloquy between Colonel A. H. Carter, President of the New York State Society of Certified Public Accountants and Senators Reynolds and Barkley in Hearings on S. 875, 73d Cong., 1st Sess. (1933) at pp. 57-58 before the Senate Banking and Currency Committee:

> "Senator BARKLEY. Do you not think it more in the interest of the public that is to buy these securities, if there is to be any check up or any guarantee as to the correctness, that it be done by some Government agency rather than by some private association of accountants?
>
> "Mr. CARTER. I think it is an impractical thing for the Government agency to do it effectively.
>
> "Senator REYNOLDS: Why?
>
> "Mr. CARTER. Because it involves such a large force. It involves the question of time.
>
> "Senator REYNOLDS. Well, it would not require any more time on the part of government officials to make a check up and audit than it would by private individuals, would it?
>
> "Mr. CARTER. I think the public accountant is better equipped to do that than the average government agency would be able to do that."

severe operational and financial problems that occurred in the securities industry in 1967-70, when many brokers became insolvent and when it became apparent that further legislation to protect the customers of broker-dealers was necessary. As the report of the Senate Committee on the Securities Investor Protection Act observed:

> "The securities industry has for some time been in a precarious position. A number of events have conspired over the past few years to create a significant number of failures of brokerage firms both large and small, and substantial operating losses in many others. The rapid growth of the industry during the 1960's, spurred by the erroneous unanticipated increase of trading volume, laid the foundation for the industry's present difficulties. Increasing volume could not be handled by traditional methods, and by the latter part of the decade evidence mounted of general breakdown in the industry. 'Fails' to deliver securities became a commonplace complaint, errors of reporting and accounting, as well as fraud, multiplied." 17/

SIPA was, therefore, intended to "* * * arrest [the turmoil in the securities industry], restore investors' confidence in the capital markets, and upgrade the financial responsibility requirements for registered brokers and dealers." SIPC v. Barbour, 421 U.S. 412, 415 (1975). It does this in two principal ways: first, it increased the Commission's authority to establish rules respecting the financial responsibility of brokers and dealers; in addition, it created SIPC, which has certain remedial powers designed to avoid, or at least minimize, the losses suffered by these customers, and within certain limits, reimburses customers of bankrupt broker-dealers for

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17/ S. Rep. No. 91-1218, 91st Cong., 2d Sess. (1970) p. 2.

losses suffered. 18/ See H. Rep. No. 91-1613, 91st Cong., 2d Sess. (1970) p. 8. As to SIPC's function in this legislative scheme, the Supreme Court noted,

> "The SEC and the securities industry self-regulatory organizations are required to notify the SIPC whenever it appears that a member is in or approaching financial difficulty. If the SIPC determines that a member has failed or is in danger of failing to meet its obligations to customers * * * it 'may apply to any court of competent jurisdiction * * * for a decree adjudicating that customers of such member are in need of the protection provided by [the Act].'"

SIPC v. Barbour, supra, 421 U.S. at 416, citing 15 U.S.C. §78eee(a)(2).

The dependence of SIPC on accurate financial statements filed pursuant to Section 17 is readily apparent. Unless a broker-dealer voluntarily informs the Commission or the self-regulatory organization of which he is a member that he is in financial difficulty, audited but inaccurate financial statements can serve to mask that fact. As SIPC points out in its brief,

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18/ Under SIPA, customers' accounts are protected to the extent of $20,000 in cash and a total of $50,000 in cash and securities. Section 6, 15 U.S.C. §78fff.

SIPC is funded by assessments on its members. In addition, it has general borrowing authority, secured by future assessments upon its members, and may borrow up to $1 billion from the Commission in the form of notes or other obligations issued by the Commission to the Secretary of the Treasury. Section 4 of SIPA, 15 U.S.C. §78ddd.

As the Commission pointed out in its "Study of Unsafe and Unsound Practices," H. Doc. No. 92-231 (1971) p. 30, the $1 billion in Treasury funds which are available in the event they are needed to accomplish the goals of SIPC "are not an inexhaustable amount and also, as public funds, require protection." The legislation creating SIPC was urgently needed because the trust fund which had been maintained by the New York Stock Exchange to pay injured customers of insolvent member firms was at the time "at the point of exhaustion." Id. at 23.

to the extent that notification to SIPC "that a member is in or approaching financial difficulty" is delayed, SIPC will be prevented from carrying out its remedial functions to protect the customers of impaired broker-dealers. See SIPC brief, pp. 30-32.

Since SIPC is an insurance fund (15 U.S.C. §78fff), to the extent that SIPC advances monies to a trustee to satisfy the claims of customers of bankrupt broker-dealers within the statutory limits established by SIPA, "SIPC shall be subrogated to the claims of such customers" against the broker-dealer. 15 U.S.C. 78fff. By operation of law, therefore, it acquires the interests of the customers of the broker when it satisfies any customers' claims against a broker. Accordingly, it succeeds to whatever rights the customers of a broker or dealer may have pursuant to Section 17 of the Securities Exchange Act and the rules thereunder. 19/ Of course, the subrogation provision contained in SIPA also strongly suggests that SIPC should have an implied right of action to recover any funds caused to be paid out by the wrongful conduct of others.

The lower court principally relied on two recent decisions for the proposition that SIPC is not within the class of persons especially intended to be benefitted by Section 17. In Piper v. Chris-Craft Industries, Inc.,

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19/ The statement of the lower court that SIPC could not possibly have been meant to be protected by Section 17 "if for no other reason because SIPA legislation was not passed until more than thirty years after Section 17" (A. 407a), ignores the fact that as subrogee of the customers of broker-dealers, SIPC's interest is identical to that of the customers, and the protection afforded by the statute to customers has not significantly changed.

supra, ___ U.S. ___, [1976-77] CCH Fed. Sec. L. Rep. ¶95,864 (1977), the Supreme Court provided some guidance for determining whether a plaintiff is within the class of persons especially benefitted by a statutory provision. The Court there indicated that a member of the class Congress intended to regulate cannot assert a claim for damages based on violations of a statutory provision intended to benefit an entirely distinct class. Chris-Craft involved a suit by an unsuccessful tender offeror trying to acquire control of Piper Aircraft Corporation. It alleged that Bangor-Punta Corporation, the successful bidder, had achieved control of Piper as a result of violations, inter alia, of Section 14(e) of the Securities Exchange Act. The Court pointed out, however, that Section 14(e) was intended for the benefit of investors who are confronted with a tender offer, i.e., the shareholder offerees, and not the tender-offeror.

Similar reasoning underlies the decision of this Court in Lank v. New York Stock Exchange, 548 F.2d 61 (1977), also relied upon by the court below. There the receiver of a former member of the New York Stock Exchange, Pickard & Co., who stood "in the shoes of" the broker and could, therefore, "assert only those claims which the [broker] could have asserted," 548 F.2d at 67, argued that damages resulted from the Exchange's knowing failure to enforce its own rules against Pickard. The action was brought under Section 6 of the Securities Exchange Act. The court denied recovery, however, because the purpose of Section 6 is to protect investors,

> "* * * whose interests may often be antagonistic to those of exchange members, and it could well have a seriously disruptive effect on the securities industry

> and the national economy itself were we to require an exchange so to enforce its rules as to avoid possible risk to its own members and their creditors and stockholders in such a way that the interests of the public investors, paramount in the legislative scheme, are disregarded." 548 F.2d at 66.

The receiver in Lank, however, is different from SIPC, which stands in the shoes of the customers of the bankrupt broker.

The lower court, we submit, erred in relying on Piper and Lank. Neither SIPC nor the customers of registered brokers and dealers are among the persons regulated by Section 17(a). Rather, the customers are the very class intended to be especially benefitted by this provision, and SIPC, as a matter of law, succeeds to their interests as a result of its payment of their claims. The court's concern in Lank was that it not extend the availability of an admitted private right of action under Section 6 beyond the especially protected class. 20/ Nothing of the sort is involved here, where the class of persons seeking protection is the very class which is the beneficiary of the protection afforded by the statutory and regulatory scheme. Like the antifraud provision of the Investment Advisers Act considered by the Court in Abrahamson, Section 17(a) and the rules enacted thereunder are "designed to protect specific classes of injured parties." [1976-77] CCH Fed. Sec. L. Rep. at 91, 274. Recognition of a private right of action for violations of the statute and rules is necessary to ensure that those parties receive the intended benefit of these provisions.

20/ "The issue in this case * * * is not whether the rule allowing a private right of action should be reversed, but whether it should be extended." 548 F.2d 61, 66.

B. The Clear Purpose of Section 17 Implies the Existence of a Private Right of Action for Willful Violations of that Provision.

As is the case with respect to most of the provisions of the federal securities laws, there is no express legislative history bearing one way or the other on the issue of whether a private right of action should be implied for violations of Section 17(a) or the rules which Congress authorized the Commission to promulgate thereunder. 21/ As this Court noted in Abrahamson, supra, [1975-76] CCH Fed. Sec. L. Rep. at 91,275, however, "[h]ad Congress provided explicitly for private damage actions it would be unnecessary to consider whether the remedy should be judicially implied." Accordingly, "absent specific statements of legislative intent, we must examine the legislative purposes underlying the Act."

In J. I. Case Co. v. Borak, supra, 377 U.S. at 432 (1964), the Supreme Court stated that the fact that the principal purpose of Section 14 of the 1934 Act is the protection of investors "certainly implies the availability of judicial relief, where necessary to achieve that result." 22/ Because the statutory provision involved here is concerned with reports filed by brokers and dealers

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21/ Only a few of the provisions of the securities laws provide expressly for private damage actions (see, e.g., 15 U.S.C. §§77k, l and o (Securities Act); 15 U.S.C. 78i(e), 78p(b), 78r, 78t (Securities Exchange Act); §77www (Trust Indenture Act); but for many years courts have implied the existence of such private rights for violations of numerous other provisions. See cases collected in Franklin National Bank v. L. B. Meadows and Co., 318 F. Supp. 1339, 1341-42 (E.D. N.Y., 1970) and cited in SIPC Brief, pp. 38-40.

22/ In Borak, the Court held that "it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose." 377 U.S. at 433.

with the Commission, the lower court indicated that Section 18 of the Securities Exchange Act, 15 U.S.C. 78r, relating to securities transactions made in reliance on false or misleading statements filed pursuant to the Act, 23/ provided the only source of civil liability for violations of Section 17 (A 40la). 24/ We submit that the court incorrectly disregarded the fact that various provisions of the federal securities laws are addressed to specific concerns other than the relationship between purchasers and sellers of securities. Courts for many years have implied private rights of action for violations of reporting and other provisions of the federal securities

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23/ Section 18 of the Securities Exchange Act, 15 U.S.C. 78r, provides in pertinent part:

> "(a) Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this title or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 15 of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading."

24/ All of the cases cited by the district court for this proposition involved violations of Section 13 of the Securities Exchange Act, which is concerned with those reports which issuers and certain purchasers of securities are required to file. Meer v. United Brands Co., CCH Fed. Sec. L. Rep. ¶95,648 (S.D. N.Y., July 6, 1976); Myers v. American Leisure Time Enterprises, 402 F. Supp. 213 (S.D. N.Y., 1975), affirmed without opinion, 538 F.2d 312 (C.A. 2, 1976); In re Penn Central Securities Litigation, 347 F. Supp. 1327 (E.D. Pa., 1972), modified on other grounds, 357 F. Supp. 869 (E.D. Pa., 1973), affirmed, 494 F.2d 528 (C.A. 3, 1974). For the purposes of this brief, we merely distinguish these cases, without discussion of our serious doubts as to the wisdom of their holdings. Contra: Kroese v. Crawford, [1961-64] CCH Fed. Sec. L. Rep. ¶91,262 (S.D. N.Y., 1963).

laws that are not limited in their application to specific transactions in securities, and where the plaintiff was neither a purchaser or seller of securities. 25/

For example, in J. I. Case Co. v. Borak, supra, 377 U.S. 426 (1963), a stockholder alleged a breach of his and other stockholders' pre-emptive rights due to a merger allegedly effected by the use of a false and misleading proxy statement (which, like the financial reports filed by broker-dealers, is a "document filed [with the Commission] pursuant to" the Securities Exchange Act within the meaning of Section 18). No purchase or sale of security was involved, but the Court, noting that the purpose of Section 14(a) is not limited to the elimination of fraud in connection with securities transactions, but includes the prevention of "management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation," 377 U.S. at 431, concluded that a cause of action under Section 14(a) is asserted if the plaintiff shows a nexus between the alleged violation of the proxy rules and injury of the type that the statute is designed to prevent. 26/

25/ All of the provisions of the Securities Exchange Act should be construed "flexibly to effectuate its remedial purposes." Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963), and, as this Court has recognized, this is especially true when courts "are asked to determine whether there should be a private right of action to recover damages for what may be clear violations of the Act." Abrahamson v. Fleschner, supra, [1976-77] CCH Fed. Sec. L. Rep. at 91,276. As Abrahamson indicates, the need for flexible interpretation of the securities laws to effectuate the Congressional purpose does not end with those provisions which deal with fraud committed "in connection with" the purchase or sale of securities. See infra, p. 20.

26/ See also Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970); Cohen v. Colvin, 266 F. Supp. 677 (S.D. N.Y., 1967); Hoover v. Allen, 241 F. Supp. 213 (S.D. N.Y., 1965); Barnett v. Anaconda Co., 238 F. Supp. 766 (S.D. N.Y., 1965).

Similarly, ever since Baird v. Franklin, 141 F.2d 238 (C.A. 2, 1944), in which the customer of a bankrupt broker sued the New York Stock Exchange for failing to enforce its own rules against the broker in violation of Section 6 of the Securities Exchange Act, courts have recognized a private right of action for violation of Section 6. 27/ Private rights of action have also been allowed for alleged violations of Section 13(a) of the Securities Exchange Act, which requires that accurate periodic reports be filed with the Commission and sent to shareholders, 28/ and for violations of the security registration provisions set forth in Section 12(g) of the Act. See, e.g., Kerber v. Kakos, 383 F. Supp. 625, 628-629 (N.D. Ill., 1974), where the court pointed out that

> "Corporate reporting is an essential cog in the proper functioning of the markets. Reporting requirements, relating to the registration of [a security on a national securities exchange], do not exist merely for the administration convenience of the SEC. They serve a very real protective function. They, like the anti-manipulative provisions, are aimed at protect-

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27/ Section 6 requires, as a prerequisite to registration with the Commission, that the Exchange enact rules designed to enforce compliance with the provisions of the Securities Exchange Act and the rules and regulations issued thereunder, and to formulate and enforce rules for disciplining and suspending members who violate these provisions.

In New York Stock Exchange v. Sloan, 394 F. Supp. 1303 (S.D. N.Y., 1975), the court held that the limited partners and subordinated lenders of a failing brokerage firm had standing to assert a private right of action against the New York Stock Exchange under Section 6. See also Hughes v. Dempsey-Tegeler, Inc., 534 F.2d 156 (C.A. 9, 1973); and Pettit v. American Stock Exchange, 217 F. Supp. 21 (S.D. N.Y., 1963).

28/ See, e.g., Kroese v. Crawford, supra, [1961-64] CCH Fed. Sec. L. Rep. ¶91,262 (S.D.N.Y., 1963).

> ing against direct private injury. * * * Certainly the protection * * * [afforded by Section 12(g)] * * * is no less important than the protections of the antifraud provisions."

Finally, the decision of this Court in Abrahamson v. Fleschner, supra, [1976-77] CCH Fed. Sec. L. Rep. at 91,276 (1977), is instructive in this regard. There the Court held that a private right of action exists for violations of the antifraud provisions of the Investment Advisers Act, even though the plaintiffs did not satisfy the purchaser-seller test applicable to causes of action under Section 10(b) of the Securities Exchange Act and Rule 10b-5. 29/ As the Court observed, the purchaser-seller requirement derives from the express language of Section 10(b) and Rule 10b-5 requiring a fraud "in connection with the purchase or sale of any security," and neither Section 206 of the Investment Advisers Act nor the rules issued thereunder contains such a requirement. 30/ More importantly, the court stated, such a requirement would be inconsistent with the interests Congress intended to protect in enacting the provision in question, since fraud on the part of investment advisers may take a variety of forms, not all of which are "in connection with" a specific securities transaction. "The purpose of the Advisers Act was 'to protect the public and investors against malpractice

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29/ See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), in which the Supreme Court adopted the "purchaser-seller" test enunciated by this Court in Birnbaum v. Newport Steel Corp., 193 F.2d 461 (C.A. 2), certiorari denied, 343 U.S. 956 (1952), with respect to violations of Section 10(b) and Rule 10b-5.

30/ The Supreme Court has indicated in recent decisions interpreting the federal securities laws that the "starting point in every case involving construction of a statute is the language itself." Blue Chip Stamps, supra, 421 U.S. at 756; Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976).

by persons paid for advising others about securities.' * * * Congress intended to protect investors against frauds committed by investment advisers who managed their clients' funds, as well as fraud committed by advisers who did not make purchases and sales for their clients." 31/ Accordingly, "if the claims of a client whose adviser managed his funds were held to be too speculative simply because the client failed to allege that he would have taken some remedial action if he had known the truth, a large segment of those investors whom Congress meant to protect would be excluded from the Act's coverage." 32/ In a like manner, customers, whom Congress intended to protect in enacting Section 17 and related statutory provisions, will be excluded from the intended benefits if a private right of action is not recognized.

C. A Private Right of Action is Consistent with the Underlying Purposes of the Legislative Scheme.

Allowing SIPC a private right of action under Section 17(a) against accountants who undertake to audit the financial statements of a registered broker or dealer and then violate their duty to perform an adequate audit is fully consistent with the underlying purposes of that provision. 33/

31/ [1975-76] CCH Fed. Sec. L. Rep. at 91,274.

32/ Id. at 91,276.

33/ In Ernst and Ernst v. Hochfelder, 425 U.S. 185, 194 (1976), the Supreme Court indicated that a private cause of action for damages under Section 10(b) and Rule 10b-5 requires a showing of "scienter," while leaving open the possibility that reckless behavior is sufficient for liability. whether scienter is required for a cause of action under Section 17(a) is not an issue here, since SIPC has alleged scienter in its complaint, an allegation which must be accepted as true for purposes of this appeal. In addition, the Court implied that reliance on the financial statements, which SIPC also alleges, is also necessary for liability, 425 U.S. at 192 n.9. See SIPC brief, p. 10.

This is not a case like Securities Investor Protection Corp. v. Barbour, supra, 421 U.S. 412 (1975), where the Supreme Court held that an implied right of action would not be consistent with the statutory scheme involved in that case. There, the Court ruled that a customer of a broker (or his representative) had no private right of action under Section 7(b) of the Securities Investor Protection Act of 1970 ("SIPA"), 15 U.S.C. §78ggg(b), to compel SIPC to provide coverage for a failing brokerage firm, but that only the Commission had that right. Section 7(b) of SIPA expressly authorizes this Commission to apply to a United States district court "for an order requiring SIPC to discharge its obligations under" SIPA, in the event that SIPC refuses to commit its funds or otherwise to act for the protection of the customers of any broker-dealer which is a member of SIPC. 34/ The plaintiff in that action, a court-appointed receiver of a registered broker-dealer, brought suit under this statutory provision, asking that the Commission and SIPC be ordered to show cause why SIPC should not be required to intervene in the action and extend the protections of SIPA to the customers of the brokerage firm.

The Court held that the overall structure and purpose of the legislative scheme involved in that case was incompatible with an implied right

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34/ Under the Securities Investor Protection Act, SIPC may apply to a court for a decree initiating liquidation proceedings if it determines that a member has failed or is in danger of failing to meet its obligations to its customers and that one or more specific conditions exists. 15 U.S.C. 78eee(a)(2). If the application is granted, SIPC is obligated, if necessary, to advance moneys to meet certain customer claims from a fund established and maintained by required contributions from its members. 15 U.S.C. 78fff(f).

of action because a private party such as the customer of a broker-dealer would rarely consider the public interest in determining whether to bring an action to compel proceedings under SIPA. For this reason, the Court noted, Congress put SIPC in the hands of a public board of directors, responsible to an agency experienced in the regulation of the securities markets. The Commission was, therefore, specifically empowered by Congress to do exactly that which the private plaintiff was attempting to do--a situation radically different from the instant case. 35/ Here, if SIPC cannot

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35/ A similar factual situation was presented in National Railroad Passenger Corp. v. National Association of Railroad Passengers, 414 U.S. 453 (1974), on which the Court strongly relied in Barbour, see 421 U.S. at 420. There, the plaintiffs had sued to enjoin the discontinuance of a particular service as announced by the National Railroad Passenger Corporation (Amtrak) pursuant to its authority under the Rail Passenger Service Act. The Court noted, however, that the statute

> "* * * made express provision for suits against Amtrak to enforce its duties and obligations only 'upon petition of the Attorney General of the United States or, in a case involving a labor agreement, upon petition of any employee affected' by the agreement. 45 U.S.C. §547(a)."

421 U.S. at 418-419. Accordingly, the effect of permitting private lawsuits to prevent the discontinuance of passenger trains, as the Supreme Court observed in Barbour, supra, would be "to substitute the federal district courts for the state or federal administrative bodies formerly required to pass upon proposed discontinuance," 414 U.S. at 462.

Compare, Allen v. State Board of Elections, 393 U.S. 544 (1969), a case arising under the Voting Rights Act of 1965, in which the Court allowed a private citizen a private right of action under that Act to set aside a state or local election law, principally because "the Act would be practically unenforceable against the many local governments subject to its strictures if only the Attorney General were authorized to sue." SIPC v. Barbour, supra, 421 U.S. at 424. Here, given the large number of registered broker-dealers and the inability of the Commission itself to audit financial statements submitted pursuant to Section 17, there is an analogous consistency with the underlying purposes of the Securities Exchange Act provision involved here.

maintain an action to recover the funds it has paid to customers, there does not appear to be any way for SIPC to recover such funds. 36/

The Supreme Court in Barbour had no difficulty in differentiating between the different considerations present there and in J. I. Case Co. v. Borak, supra, where "the Court agreed with the SEC that private enforcement of the proxy rules was a necessary supplement to SEC enforcement," rather than an interference. Id. at 424. Thus, while the Securities Exchange Act and SIPC are similar in that "Congress' primary purpose in enacting the SIPA and creating SIPC was, of course, the protection of investors," id. at 421, the Commission opposed recognition of the private right of action asserted in Barbour because an implied right of action under SIPC would not promote that goal. And the Supreme Court agreed that suits by investors "who deem themselves to be in need of [SIPA's] protection" were not "capable of furthering that purpose." Id.

Unlike Barbour, however, the statute involved here is designed to protect and benefit directly a particular segment of the investing public, the customers of brokers and dealers, like the proxy-regulating statute in J. I. Case Co. which was intended to benefit shareholders exercising their corporate suffrage. In that case, the Court observed that

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36/ If an action is permitted on the causes of action alleged by the trustee, perhaps a portion of any recovery would benefit SIPC as subrogee of the claims of the customers. Presumably, recovery in any action brought by customers would be limited to losses in excess of the SIPC payment, which cannot exceed statutory limits (see p. 12, fn. 18). The Commission itself has no authority to bring an action seeking damages due to violations of the securities laws.

> "* * * it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose."

377 U.S. at 433. The Commission believes that the existence of implied rights of action under such provisions as Sections 14(a) and 10(b) of the Securities Exchange Act has promoted the goals of those provisions and has not interfered with the legislative scheme in any way. On the contrary, such actions are, indeed, a "necessary supplement to Commission action" taken to enforce the law, since, as this Court recently noted,

> "the SEC--the agency charged with administrative and enforcement of the federal securities laws--does not have sufficient resources alone to enforce the many provisions of the statutes. Absent judicial recognition of private rights of action, the federal securities laws most assuredly would fail to provide the effective regulation over the securities industry which Congress intended."

Abrahamson v. Fleschner, supra, [1976-77] CCH Fed. Sec. L. Rep. at 91,274. 37/

37/ The cause of action asserted herein by SIPC is thus fully consistent with rights of action recognized by the courts in contexts other than those involving securities transactions. The lower court indicated that it believed that civil liability for violations of Section 17 is not necessary to enforce that Section, since the Government has the authority to bring criminal actions and suits for injunctive relief for such violations. These remedies do not, of course, compensate parties injured by willful violations of Section 17, nor will they, by themselves, provide an effective deterrent to such violations.

Although the Commission's broker-dealer inspection program is an extensive one, the Commission does not have the resources to audit the financial statements submitted pursuant to Section 17. In fiscal year 1976, over 5,000 brokers and dealers were registered with the Commission. Each of the approximately 750 broker-dealers who are not members of self-regulatory organizations are examined by the Commission every year for compliance with Commission regulations; the self-regulatory organizations examine each of their members annually for the same purpose. The Commission also conducts each year oversight examinations of roughly 5 percent of the broker-dealers who are members of self-regulatory organizations. In addition, a broker-dealer may

(footnote continued)

For the same reasons, an implied right of action under Section 17 of the Securities Exchange Act will not interfere with the Commission's administration of that Act; indeed, it will provide a useful and a needed supplement to Commission action. 38/

D. The Cause of Action Asserted by SIPC pursuant to Section 17 is One Arising Under Federal Law Which is Not Necessarily Equivalent to Any Cause of Action Available Under State Law.

The legislative history and other material relating to the evolving protections afforded customers of broker-dealers, discussed supra, makes abundantly clear that the problems that arise in connection with broker-

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37/ (continued)

be examined for "cause" (usually as a result of a complaint received) and each year about 500 broker-dealers are examined for this reason. Once a broker-dealer is identified as being in or approaching financial difficulty, much closer scrutiny is provided by the Commission. Until this occurs, however, all regulatory bodies are dependent upon the reports supplied by broker-dealers and the independent verification provided by the annual audit performed by independent accountants.

The threat of private damage actions would provide an effective supplement to Commission enforcement action which would help to assure proper professional conduct. The Commission believes that, absent judicial recognition of private rights of action, the securities laws will, in a significant respect, fail to provide the effective protection for customers of broker-dealers that Congress intended they should have.

38/ In considering the "policy considerations" with respect to the need for the purchaser-seller requirement for a cause of action under Rule 10b-5, the Supreme Court expressed its concern that vexatious or frivolous litigation not be encouraged. Blue Chip Stamps v. Manor Drug Stores, supra, 421 U.S. at 737, 743 (1975). The Court also noted the desirability of excluding actions in which the damages alleged were the largely speculative claims of persons who were neither purchasers nor sellers of securities but mere "bystanders to the securities marketing process * * *." Id. at 747. These concerns are not relevant in the circumstances of this action. Since most claims of investors, including all the claims of small investors, are now paid by SIPC, there is little danger that the customers of insolvent broker-dealers will institute class action "strike" suits having little merit but,

(footnote continued)

dealer insolvencies are national in scope. 39/ A federal reporting standard for broker-dealers has, as we have pointed out, existed since the enactment by the Commission of Rule 17a-5 in 1942, and has periodically been amended

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38/ (continued)

perhaps, some settlement value. And, since the decision made to institute suit to recover funds expended by SIPC due to violations of the securities laws will be made by a corporation which is established by Congress, has a board of directors consisting of two designees of high-level government officials and five Presidential appointees (subject to Senate confirmation), and is subject both to extensive oversight by this Commission as well as to Congressional scrutiny, the danger that any suits that are instituted will be frivolous is minimal. Moreover, SIPC can only institute actions after it has suffered actual monetary damages in a specific amount—i.e., the extent of its actual payments to customers.

Similarly, in Ernst & Ernst v. Hochfelder, supra, 425 U.S. at 214 n.33, the Court expressed its concern that the class of potential plaintiffs not be broadened to include persons who concededly had not relied upon financial statements audited by the defendant accounting firm. But here, as we have pointed out, the entire regulatory scheme involved depends upon the accuracy of the reports filed by brokers, and this fact is presumably well-known by any accounting firm which audits a broker which is a member of SIPC. In any event, the allegations made by SIPC include the failure of the audited reports adequately to convey a factual picture of the financial condition of Weis Securities and, as the Supreme Court has held, reliance on material facts which have been omitted may sometimes be presumed. Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972).

39/ The adverse effects of the brokerage house crisis of 1967-70 on "this vital sector of the nation's economy, the securities markets," were noted in the Study of Unsafe and Unsound Practices of Brokers and Dealers," supra, H. Doc. No. 92-231, 92d Cong., 1st Sess. (December 1971) at pp. II-12, which stated that "the plain task of all segments of the nation concerned with public protection in this area" was to effectuate a cure for the structural weaknesses in the securities industry. These defects, if not remedied,

> "may produce an unwarranted drain on the resources of SIPC or leave untouched the exposure of public investors to the risk of loss of funds and securities not covered by SIPC. Investors' confidence in the United States securities markets could again be threatened."

Similarly, the House Report on SIPA noted that brokerage house failures "may lead to loss of customers' funds and securities with an inevitable weakening of confidence in the United States securities markets. Such lessened confidence has an effect on the entire economy." H.R. Rep. No. 91-1613, 91st Cong., 2d Sess. (1970) p. 2.

to enhance the protections it provides to shareholders. On the other hand, the protections and remedies afforded customers of brokers and dealers under state law vary widely, and cannot reasonably be expected to serve the purposes for which the statutory and regulatory provisions here in issue were enacted.

The plaintiffs herein are asserting a federal cause of action that is, therefore, not necessarily equivalent to any cause of action they may have under state law. Violations of the provisions of the Securities Exchange Act generally are matters which the Congress deemed detrimental to the national public interest, and resort to the federal district courts is specifically made available to plaintiffs injured by violations of the Act. 40/

* * *

As we have seen, the cause of action asserted herein by SIPC fully satisfies the criteria enunciated by the Supreme Court. Such a right of

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40/ Pursuant to Section 27 of the Securities Exchange Act, 15 U.S.C. 78aa, federal courts are given exclusive jurisdiction over violations of the Act and all actions at law brought to enforce duties created by the Act. The Supreme Court in J. I. Case Co. v. Borak, supra, 377 U.S. at 433, emphasized the jurisdictional provisions of the Act in holding that there is an implied right of action under Section 14(a):

> "'* * * where legal rights have been invaded, and a federal statute provides for a general right to sue for such invasion, federal courts may use any available remedy to make good the wrong done.' [citation omitted] Section 27 grants the District Courts jurisdiction 'of all suits in equity and actions at law brought to enforce any liability or duty created by this title * * *.' In passing on almost identical language found in the Securities Act of 1933, the Court found the words entirely sufficient to fashion a remedy to rescind a fraudulent sale, secure restitution, and even to foreclose the rights to restitution against a third party holding assets of the vendor."

action will afford necessary protection against depletion of the SIPC trust fund caused by violations of the federal securities laws and will thereby promote the legislative purpose of protecting customers who trust their funds or securities to the safekeeping of their broker. Such a right of action would also help to assure that the financial statements prepared by brokers and dealers, and audited by independent accountants, are reliable, thus strengthening the regulatory scheme in important respects.

CONCLUSION

For the foregoing reasons, the order of the district court dismissing the action should be reversed.

Respectfully submitted,

PAUL GONSON
Associate General Counsel

JAMES H. SCHROPP
Assistant General Counsel

THEODORE S. BLOCH
Attorney

Securities and Exchange Commission
Washington, D.C. 20549

August 1977

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE
GENERAL COUNSEL

8/22/77 called 8/23 for notice of motion form

August 19, 1977

A. Daniel Fusaro, Esquire
Clerk, United States Court of
Appeals for the Second Circuit
U. S. Courthouse
Foley Square
New York, New York 10007

Re: Redington, et al. v. Touche Ross & Co., Nos. 77-7183 and 77-7186

Dear Mr. Fusaro:

Enclosed for filing in the above-captioned appeals is the Motion of the Securities and Exchange Commission for Leave to File Brief Amicus Curiae in the Form Submitted herewith. If the Commission's motion is granted, ten copies of the brief are enclosed for filing.

I certify that two copies of the Commission's brief have been served on counsel for the parties to these appeals.

Sincerely,

James H. Schropp
Assistant General Counsel

Enclosures

cc: Kelly Nevling, Esquire
Rosenman, Colin, Freund, Lewis
& Cohen
575 Madison Avenue
New York, New York 10022

Rafael Pastor, Esquire
Hawkins, Delafield & Wood
67 Wall Street
New York, New York 10005

John S. Allee, Esquire
Hughes, Hubbard & Reed
One Wall Street
New York, New York 10005

Michael Don, Esquire
Securities Investor Protection
Corporation
900 17th Street, N.W.
Washington, D.C. 20006